DR. KURT RICHEBÄCHER

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8001 Zurich

Currencies and Credit Markets

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Historical myths have perhaps played nearly as great a role in shaping opinion as historical facts. Yet we can hardly hope to profit from past experience unless the facts from which we draw our conclusions are correct.

Friedrich A. Hayek, *History and Politics*

Highlights:

An elaborate mythology regarding the events which occurred before and after the 1929 crash is deluding analysts into believing that the 1987 experience is somehow different, somehow less ominous in its causes and its consequences. Nothing could be further from the truth.

After the 1929 crash, the Federal Reserve board did *not* tighten money as most monetarists would have you believe. Nor was the Depression aggravated by stringent fiscal policy as is commonly stressed by the Keynesian historians.

Rather, the roots of the 1929 crash and Depression -- both in the U.S. and in Europe -- stem from the speculative excesses which preceded the crash and which no amount of policy switches could have undone. The banking crisis of the 1930s did play a role. But its importance is exaggerated. The big financial damage took place in the financial markets. What's more important is the fact that today the banks have actually less liquidity than they did in 1929.

Thus, neither the monetarists nor the Keynesians are truly capable of explaining why the Depression occurred. Rather, we must rely more heavily on the classical economists who stress the credit and debt creation -- as well as the use to which the borrowed money is put -- rather than just the *quantity* of money in the system.

The experience of Germany in the 1930s provides a good illustration of the dangers of a speculative boom/bust, with the added factor of excessive dependence on foreign money. Although direct comparisons are, as always, problematical, the lessons to be learned for the U.S. today are numerous.

We can only conclude that the 1927-29 and 1985-87 periods are mirror images. But there is one big difference between then and now: This time it's worse! The record-smashing U.S. trade deficit announced just moments before we go to press is just one of the many evidences of that sorry fact of life. In this report, we present many others which are bound to come as a shock to many observers.

It is out of this major difference that we see events unfolding along somewhat different lines, especially in the bond markets and the dollar.

With everyone talking about the crash of 1929 and the "great blunders" committed by the policy makers of that era, we think it's high time to make some careful comparisons between then and now. Most of our readers will be greatly surprised to learn that much of what they believe about the events and policies of the 1930s are not firmly established facts. They are merely *myths* created by economists -- both Keynesian and monetarist -- into whose general beliefs and theories they fitted.

Myth #1. Whereas the crash of 1929 was preceded by unrestrained speculative excesses, the period immediately prior to the 1987 crash was characterized by "healthy skepticism" among investors, helping to keep the speculative fever in check.

Here are the facts:

1929: When the U. S. stock market crashed in late October 1929, stocks, on average, were trading at slightly less than 14 times earnings, actually *down* from an earlier peak of 16.2 made in January of that year. By year-end, a mere two months later, the price-earnings ratio had fallen to 9.8. Meanwhile, in the fixed instruments, when the crash struck, yields ranged from 3.4% for government bonds to 5.1% for corporates.

1987: When the crash hit, stocks were trading at an average of *24 times* earnings, *up* dramatically from the 1984 levels. Meanwhile, dividends were horrendously low, providing stock investors with a paltry 2.7% yield, as compared with government bond yields in excess of 10%.

Never before in history have U.S. stocks been so grossly overvalued relative to earnings! Never before have they been so far out of synch with interest rates or with the underlying fundamentals -- the budget deficit, the availability of savings, and the great demands for them.

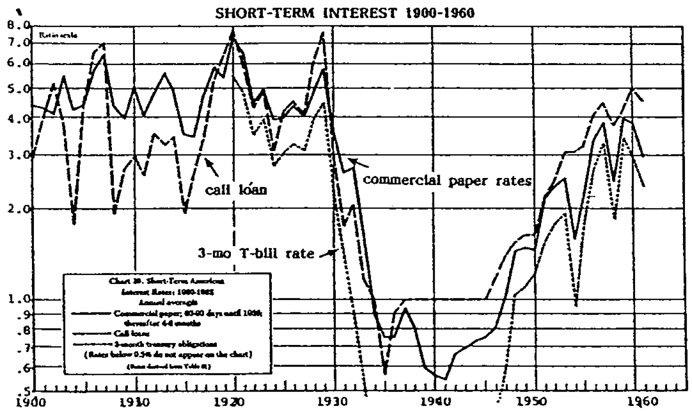
Myth #2: After the October 1929 stock market crash, America's Federal Reserve Board foolishly responded by tightening money and slashing the money supply, plunging the world into the Great Depression. Having learned their lesson, today's governments and central banks are aware that their first concern must be to avoid a financial collapse and to do everything within their power to maintain confidence. Thus, central banks have had no hesitation this time in injecting additional liquidity into the system.

Again, the facts indicate otherwise. Yes, the Fed has been pumping in liquidity. But a hard-nosed comparison of the actual numbers and events reveals that, ironically, their response to the October 1929 crash was actually *more aggressive* than today's.

Yes, there did occur a sharp fall in the U.S. money supply. *But that decline did not begin until after March 1931 when the U.S. economy was already in deep recession.* At the end of 1929, the money supply was the same as a year earlier ($22.6 billion), despite the massive reduction of broker loans from $8.5 to $4.0 billion immediately after the crash. They were not tightening. The truth is that, during the days and weeks immediately following the 1929 debacle, in a radical departure from previous policy, the Fed plunged in aggressively to ease money. Consequently, whereas in most panics and crashes prior to 1929 when interest rates naturally skyrocketed, this time they were deliberately held down by immediate and massive Fed purchases of government securities.

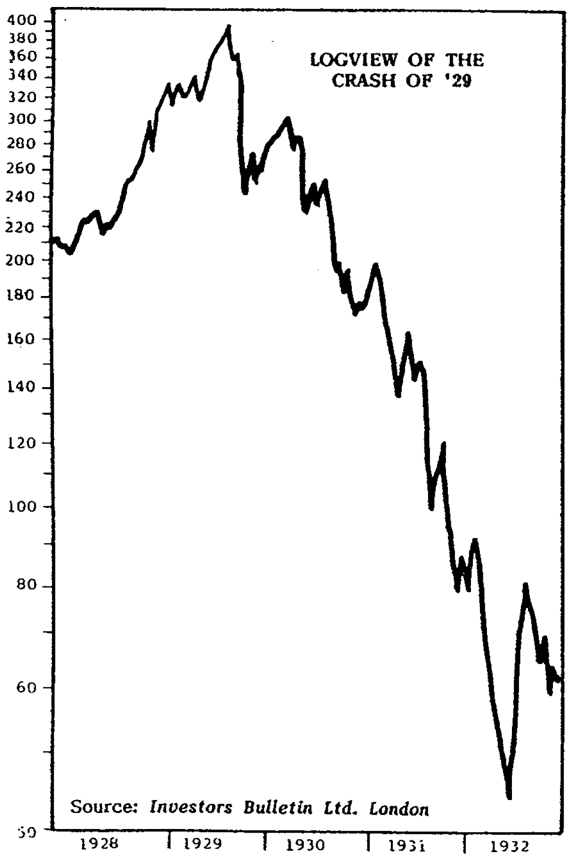
Only one week following Black Tuesday -- on November 1, 1929 -- the Fed reduced its discount rate from 6% to 5%. On November 15, it was dropped to 4.5%; and on January 20, to 4% (see chart).

By mid-November 1929, the sharply lower interest rates were already having the desired impact: The stock market plunge came to an abrupt halt, and a sharp bear-market rebound was under way. Then, from late November 1929 to mid-April 1930, a period of four and a half months, the market recovered about half of its previous losses.



Finally, by the spring of 1930, there were widespread hopes and expectations that the crash had come ... and gone. It was purely a "financial crisis," not a true economic one, they said. The theory was that it was isolated to a small group of Wall Street speculators who gambled ... and lost; that all the others were in good shape. Everywhere it was stressed repeatedly that not a single bank or broker had failed as a result of the crash.

So it was only natural for President Hoover to declare, on March 7, 1930, that the U.S. economy was fundamentally sound. All he was doing was expressing the prevailing opinion among businessmen and forecasters.



Source: *Investors Bulletin Ltd. London*

Indeed, until about mid-1930, economic activity was holding up fairly well, on a slightly downward path but not significantly below the 1929 pace. It wasn't until the latter half of that year that things took a drastic turn for the worse. As Schumpeter puts it: "People felt that the ground under their feet was giving way. Yet, there was no panic or even alarm until, late in the year, distress signals began to go off in the banking sphere."

What most historians fail to recognize is that, *despite the fact that there was no clear evidence of the impending doom until late 1930, the Fed had been progressively cutting the discount rate throughout the entire year* -- first in a series of quick steps down to 2.5% by July, and then still further to 2% in December. In consonance with these moves, it cut its buying rate for bank acceptances from 4% in early 1930 to 1.75% in December. In short, the key interest rates were slashed to one-third their precrash levels!

As it turned out, the stock market rally stalled in April, giving way to a long bear market which would not end until March 1933 -- by which time, stocks had lost an *additional* 70% of their values, or 90% in all from the precrash peaks. (This is especially evident in the stock-market chart on the previous page, using a log scale.) But the magic wand of cheap money had lost all its power. Sharply falling interest rates proved to be a feeble candle in the dark, gloomy caverns of crashing equity markets and collapsing economies around the world.

One thing is clear: The extent and speed of the interest rate decline after the October 1929 crash was absolutely unique to that time period, unprecedented in history. Strangely enough, however, it gets little more than a passing mention by the historians of the American monetarist school. They appear to be simply unable to conceive of a recession or depression occurring for any reason other than excessive monetary tightness.

In order to squeeze the phenomenon of falling interest rates into their theory, they simply declare, without reference to historical precedent, that these unusually sharp declines were "too gradual and delayed." And it is with this long stretch of the imagination that they cross the threshold from fact to myth. According to this contorted interpretation, money was neither cheap nor easy after 1929, but "extremely tight."

The fact is that, throughout the 1930s, the Fed pursued a policy of monetary ease and extremely low interest rates with only one brief interruption in the autumn of 1931. That's when England devalued the pound and gold moved heavily out of the United States, prompting the Fed to briefly raise the discount rate. At the same time, T-bill rates were also increased briefly.

Granted, with the benefit of 20/20 hindsight, this short interlude of stringent credit can be interpreted as a policy error. But far greater errors -- with no disastrous consequences -- have been made in other times, both before and after the 1930s. Furthermore, it was an understandable one, justifiable on the basis of the rules and psychology of the gold standard.

In any event, in early 1932, short-term interest rates resumed their decline. In the course of that year, call money rates fell to 1% and commercial paper rates to 1.5%. Treasury bill rates hit a low of 0.08%. Meanwhile, American banks accumulated reserves far in excess of their legal requirements. But none of this was able to stem the tidal waves of depression.

For the rest of the world -- including Britain, Canada and most of Continental Europe -- the summer of 1932 was the turning point. But not so for the United States. Of all industrial countries, the U.S. had the deepest and longest depression, one that dragged out until America's entry into World War II. Throughout that period, industrial production failed to regain its 1929 level. By comparison, in England, it was up by 30%.

Thus, tight money did not cause the Depression; and still easier money could not have prevented it! For reasons which should soon be obvious, there are certain critical periods in the economic history of a nation when monetary policy loses its power -- when no amount of money, no matter how cheaply provided, can restore underlying confidence or inspire investors and consumers to spend it.

Myth #3: In the United States the Depression was aggravated by stringent fiscal policy. Instead of fighting the Depression with an expansive fiscal policy, President Hoover raised taxes.

Not true. The first fiscal measure enacted after the October 1929 crash was a reduction in the personal income tax rate from 5% to 4% and a cut in the corporate income tax from 12% to 11%. It had nothing to do with Keynes. It was simply to reduce a budget surplus. However, the rapidly weakening economy played havoc with public finances. Between 1929 and 1931, tax receipts fell by almost 50%, while expenditures rose by almost 60%. The result was a dramatic swing from surplus to deficit of about 3% of GNP -- roughly equivalent to a swing of $130 billion relative to the 1987 GNP.

The decision to raise taxes "in the midst of a depression" (over which the Keynesians made later much ado) was not made until October/November 1931, after the British had left the gold standard. It was this general turbulence -- associated with the flight to quality occurring especially in the U.S. -- which triggered the wild turbulence in the financial arena.

As gold began to flow out, bank reserves declined, interest rates rose, currency withdrawals spread, and bank failures surged. The Fed, correctly perceiving the gold outflow to be somehow linked to the turmoil, took action to stop it by raising its discount rate. It was to support these actions that the tax hike was enacted, also justified as a needed mechanism to reestablish fiscal balance, bolster confidence, strengthen security prices and thus restore the flow of credit.

(Sound familiar? The discipline of the gold standard may seem old-fashioned to us now. But the Gramm-Ruddman legislation of today would appear equally strange to the policy makers of the 1930s. Regardless of appearances, the fact is that both fit into a similar slot in the overall scheme of things.)

According to the Keynesians, "deficit spending failed in the United States during the Depression because the deficits were too small." Actually, they ranged between $2.5 billion and $4.5 billion. But do not let these apparently minute numbers mislead you. Compare them instead to the overall size of the budget and of the economy:

In the fiscal year ending June 30, 1932, expenditures were $4.7 billion -- nearly 2 1/2 times their meager revenues of $1.9 billion. Also consider the fact that, in reference to the GNP of that time (in the $60 billion range), the deficits were gigantic, in fact no less gigantic than Reagan's deficits today.

In short, during the 1930s, the United States had the lowest interest rates and by far the biggest budget deficits among the major industrial nations. But to no avail!

The most interesting contrary case was Britain. After the devaluation of the pound, their National Government accepted strict fiscal orthodoxy. Determined to balance the budget at any cost, in 1931, they imposed hefty increases in both direct and indirect taxes, coupled that to across-the-board cuts in government expenditures, and were able to survive the 1930s without a single budget deficit. Furthermore, despite these actions, Britain enjoyed one of the strongest recoveries of that time.

The moral of the story is clear: Those who look upon budget deficits as a sure magic for boosting economic growth should carefully study the British and the American experiences during the 1930s. (Equally misguided are those who feel that,

by belatedly and meekly reducing deficits on the brink of an economic decline, one can somehow ward off the long overdue consequences of past fiscal irresponsibility!)

Why, then, did the U.S. economy perform so much worse than others during the 1930s? That, indeed, is the big question. Most debate has been focused on the successive waves of bank failures in the United States between 1929 and 1933, involving about 9,000 banks out of the then existing 25,000. In retrospect, these numerous failures have been interpreted as another sign of excessive monetary tightness.

Did the banking crisis play a crucial role in the U.S. Depression? And what was its origin?

While 9,000 bank failures was unquestionably a shocking number, a key point to remember is that these came *after* 5,000 other banks had *already* closed their doors between 1920 and 1929, tying up deposits to the tune of $1.5 billion. Also, never forget that these precrash failures took place in an environment of economic boom and easy money!

Nevertheless, the banking crisis of the 1920s is hardly mentioned in history books. What caused it? Some of the same factors which has caused the pre-1987-crash failures: A collapse of agricultural prices and land values (after 1920); collapse of real estate speculation; the restructuring of the banking system as a whole through the elimination of very small banks. (No less than 80% of bank failures were in towns of 2,500 people or less, with more than 60% involving banks with $25,000 or less in capital.)

Nor was it a case of small banks failing before the crash and large ones after the crash. The banking crisis from 1930 through 1933 had very much the same characteristics of the earlier period -- mostly small banks with meager capital. All told, the failures inflicted only $2.5 billion in losses on stockholders, depositors and other creditors, with slightly more than half of these losses falling on the backs of depositors, representing about 2-3% of total bank deposits.

In contrast, the financial damage wrought by the stock market was far more devastating. After the October debacle, there ensued an abrupt liquidation of security loans, as margin calls went out *en masse*. Within only five weeks, up until the end of November, such loans fell from $8.5 billion to $4.0 billion; and by midsummer 1932, they were paid down to $300 million, implying similar numbers incurred in terms of losses were suffered by the borrowers.

Clearly, this massive credit liquidation had nothing to do with tight money. It was the direct consequence of the prior overborrowing for speculation.

Also compare these numbers to the $2.5 billion lost in the banking crisis: Total stock market losses in October 1929 alone -- $15 billion. Total market losses through year-end 1933 -- a whopping $85 billion, or 34 times as much as was lost in the banking crisis! In proportion to total wealth, the losses produced by bank failures were relatively minor and do not deserve all the attention that has been accorded to them by most American historians.

Milton Friedman, in his *Monetary History of the United States*, ascribes a key role to the banking crisis in keeping the U.S. economy in permanent depression. His argument: What matters is that it was the mechanism which produced the drastic decline in "the money stock," and it is this money stock which plays the critical role in economic development.

There is some truth in that. However, even if one accepts the view that the bank failures played a more important role than the sheer quantity of losses might imply, this still leaves unanswered one key question: Why did the banks fail in the first place? Was it mainly because of tight money? Or was it because of bad loans and investments financing real estate and other speculation? In other words, the argument boils down to this: Was it a failure by the Fed to provide "liquidity," or was it the lack of liquidity and the lower quality intrinsic to the loans themselves? All evidence points to the latter as being the true cause. (Again, note the error of improperly defining liquidity as we explained in our last issue.)

Monetarists have swept this point of credit quality aside with the argument that the banks and the underwriters of bonds had not *deliberately* issued unsound loans and securities. In other words, what happened later could not have been foreseen. But this is also untrue. It so happens that there were many people in the 1920s -- well before the crash and the Great Depression -- who warned of the financial excesses in the stock market and who derided the real estate speculation and foreign lending.

Obviously, the very fact that there were so many banks which did *not* fail serves as testimony that numerous sound banks and bankers had avoided bad loans and bad securities. This, in itself, is not surprising. What *is* surprising is that, in their haste to exonerate the speculative bankers of the time and shift the blame to the government, both monetarists and Keynesians alike have completely bypassed the nonspeculative majority. Yet it is this fact which most strongly suggests that the banking crisis was not all *force majeure*, and certainly not created in Washington.

Yes, there were pockets of extreme illiquidity in the banking system. But most banks were relatively liquid, both in terms of their capital and their short-term liquidity position. For example, in 1929, the National City Bank (now Citicorp) had $2.2 billion in assets vs. $1.65 billion in deposits, leaving an equity of $550 million or 25% of assets; cash and deposits with banks amounted to 25% of assets; and loans plus discounts represented only 54% of assets. Now contrast this to the latest Citicorp balance sheet (as of 6/30/87): Assets are $195 billion vs. $188 billion in deposits and borrowings, leaving an equity of $7 billion or only 3.6% of assets. Cash and equivalent items amount to only 20% of assets; while loans and discounts add up to 85% of assets. This is typical of the large, reporting member banks.

The real causes of the crisis.

What then was the major element in the financial crisis of the early 1930s in the United States? Answer: The collapse in the price of lower-grade bonds in the winter of 1931-32 -- again, not as the result of any governmental policy, but rather as direct and natural consequence of overspeculation. As defaults on bonds rapidly escalated in 1930-31, there developed a flight to quality, causing interest rates of lower-grade bonds to soar. Moody's corporate Baa bonds, which had a yield of 7.5% in August 1931, were yielding 11.6% only six months later.

This massacre in the corporate bond markets started as far back as 1929 in the field of urban real estate bonds, spreading to foreign bonds and land bank bonds by

1931. From mid-1931 to mid-1932, railroad bonds lost an average of 36% of their market value, foreign bonds 45%, and some issues even more.

Clearly the epicenter of the financial disaster lay in the market for these financial securities *as well as* in the markets of their underlying collateral assets -- housing, land, commodities, etc. Thus, *the main problem was collapsing asset liquidity which was not under the Fed's control, and which preceded -- by many years -- the financial collapse which the Fed supposedly caused.* During 1932, bank loans were being liquidated and bank deposits fell sharply. But total bank reserves were increasing and excess reserves were substantial and rapidly growing. Monetary policy was extremely easy and credit expansion possible. What the country was struggling with appeared to be not a shortage of money, but a collapse of security values and a general loss of confidence.

Two schools of thought.

In assessing the developments in the 1930s in the United States, there have always been two schools of thought:

The members of the classical school -- mainly from the Austrian school (Mises, Hayek, etc.) -- held that an excessive money and credit expansion had transformed what would otherwise have been a cyclical upturn into the unrestrained boom of the late 1920s. They stress the extreme financial and speculative excesses of that era.

According to this interpretation, the catastrophe of 1929-33 was the inevitable outcome of the overexpansive policies during the 1920s. The severity of a recession, they stated, is largely determined by the financial excesses, imbalances and maladjustments which developed during the preceding boom. And financial excesses always mean one thing: excessive credit and debt expansion. (Note that it was this group of economists that had been forewarning of the coming crash.)

The American monetarists, in contrast, have regarded the 1920s as a time of "relative deflation" as prices fell slowly. In their view, the monetary collapse from 1929 to 1933 was not an inevitable consequence of what had transpired earlier, but the result of an exceedingly tight monetary policy pursued during 1929-33.

This is the crucial difference between American monetarists and classical economists. The latter look at credit and debt creation and the use to which the borrowed money is put. Monetarists only see the sheer quantity of the money and "liquidity" creation. In fact, in his voluminous *Monetary History of the United States*, Milton Friedman never once mentions debts.

Germany of the 1930s suffers similar boom/bust pattern.

It was, of course, anything but accidental that in the 1930s the two countries that indulged in the greatest debt excesses during the preceding two years -- Germany and the United States -- also suffered the worst economic disasters, despite differences in the nature of those excesses. (In the United States it was the private sector, as opposed to the public sector in Germany.)

As in the U.S., it was the outbreak of the banking crisis during the summer of 1931 that made the German depression so particularly severe. And likewise, in most history books, the extreme severity of the depression in Germany has always been

attributed to the "savage deflationary policies" pursued by Heinrich Bruning, the German chancellor, and to the "reckless withdrawals" of foreign short-term loans which caused the German banking panic in the summer of 1931.

But in order for these "reckless withdrawals" to occur, there had to be reckless *borrowing* abroad in the first place. In 1930, only six years after the rampant inflation, German foreign indebtedness was in the region of RM 26 billion, with some 16 billion in short-term debts -- all incurred within 5 years! This compared with a GNP of RM 70 billion. In today's GNP terms, the foreign indebtedness would be equal to more than DM 600 billion.

In 1929, 48.7% of the total deposits of the commercial banks were borrowed from foreign banks, and in 1930 their share was still 44%. Thus, Germany was completely illiquid -- both internally and externally -- with large trade deficits. And all of it was due to irresponsible policies in the years before. In fact, it was mainly the German banking crisis that caused the sterling crisis in the autumn of 1931.

But economists put all the blame on Bruning's deflationist policies -- policies which were merely an 11th-hour attempt to *restore* some semblance of stability via long-overdue austerity measures.

The decisive point generally disregarded is that the problems that surfaced in 1930-31 -- with a vengeance -- were the foreseeable and inevitable consequences of irresponsible German internal policies during the years 1925-29: A rampant budget inflation. Soaring state expenditures on all levels of the public sector. And wage inflation. In 1927, wages in the public sector were raised by 20-25%. From 1925 to 1929, industrial wages rose by 33%, while productivity rose only by 5%.

Few history books mention the fact that annual public deficits in Germany during 1925-29 amounted to about 3% of GNP -- only slightly smaller than U.S. budget deficits under Reagan.

It is difficult to say who was more irresponsible at the time -- the German politicians who let deficit spending run rampant, the German banks who borrowed without restraint, or the foreign bankers who lent without regard to the potential risks. Economists, however, blame none of these for the events that followed. They attribute little to the irresponsible policies that had fostered the extremely vulnerable economic and financial conditions. Their sole concern is to find that illusive smoking gun -- the final event that triggered the crash, plus the policies which supposedly caused the depression.

The German politicians of that period had two excuses for their irresponsible policies: the post-World War I reparations mandated by Versailles and the extreme shortage of capital. Surely, the reparations did play a role. But the more important factor was the folly of reckless borrowing abroad which, in turn, allowed the Germans to heap fiscal excesses on top of the reparations. And, at the same time, the fiscal excesses caused the capital shortage and the high interest rates about which they lamented.

Are 1927-29 and 1985-87 mirror images?

Now, armed with a better understanding of the historical facts, we are ready to go back to America and to our question of what truly caused the crashes of 1929 and 1987. Then, finally, the most important question of all: What is bound to follow?

We saw how Milton Friedman and his followers put all the blame on tight money and a falling money supply. And we saw how West German historians took the same attitude vis-a-vis their government's policy at the time.

Most important, we demonstrated how the monetarist approach is incapable of explaining both the crash and the beginning of the Depression, just as it is incapable of explaining or understanding the credit inflation and the speculative excesses that preceded them.

One would think that having seen all these arguments in their history books, modern-day observers might come up with some new arguments to justify their current speculative behavior. But even that is beyond them: The debate today about causes and consequences of the crash of 1987 is the precise mirror-image of the discussions that preceded and followed the crash of 1929.

The best insight into the two opposing views which prevailed at that time is given by an incident involving Maynard Keynes, one that led to correspondence in which both sides presented their ideas. As you read the following section, note the uncanny resemblance to today's debate.

The Keynesian approach before 1929: "Don't sell your stocks!"

The time is the summer of 1928, over one year before the crash. The place is the board of directors of a large insurance company of which Keynes is a chairman. One of the board members has recommended that the firm get out of all its American securities. He argues that there is serious inflation in the United States and that the Fed will have to deal with it through a policy of tight money which will reduce stock prices. And, he adds, if the Fed does not act, the downward reaction of share prices from current levels will simply be that much more severe. In either case, he concludes, the company should sell its stocks.

Keynes -- voicing the majority opinion prevailing on Wall Street and among American, British and Swedish economists -- disagrees. In a memorandum, he asks rhetorically: "Is there inflation in the United States? What is the test of inflation?" His answer: *prices*, in particular commodity prices. Since these have been stable for years, Keynes concludes that there is no inflation.

Keynes' paper draws reaction from several of those to whom it is sent. Most worthy of note are the answers from his American correspondents -- one from Harvard, the other two from the Fed, but all bringing home the same point: *Commodity price inflation is not the only kind of inflation that matters. One must also pay close attention to other forms -- namely excessive credit inflation which is largely being funneled into speculative channels, boosting real estate and stock prices.* If this overvaluation goes unchecked, they warn, it will lead to a collapse which, through a chain reaction of bankruptcies and loss of confidence, will depress the economy.

Keynes' answer: "I see nothing inflationary in this ... if there is inflation, it must show itself sooner or later in rising prices for consumption goods." The majority of economists agree. They see no inflation. They think that the combination of stable prices and a booming stock market are the best of all possible worlds, perfect signs of economic health.

But then the disaster strikes close to home: One of the leading advocates of this optimistic interpretation -- Professor Irving Fisher, father of the monetarist school -- is one of the foremost victims of the financial tragedy. Having placed his full faith in the "new economic era," he not only loses a fortune of $8-10 million which he has pyramided on his wife's inheritance, but he winds up with debts of three-quarters of a million dollars.

Who was right?

In the aftermath of the crash, there occurred a strange power struggle among economists to prove who was right and who was wrong. In retrospect, it should be obvious that those who had correctly predicted the eventual crash of the "inflationary" stock market boom were the ones proven right by the events.
But in the rush to absolve the guilty majority, few among those who had misjudged the situation were willing to grant to the prescient forecasters their due credit. Instead, it was the interpretation propagated by the monetarists which gained credence -- namely that the crash and the following depression were caused by overly tight money.

Like in the most recent experience, there was an ardent search for scapegoats ... and those who found the best scapegoats first were also the ones who, ironically, emerged as the leading economic theoreticians for generations to come.

The big difference between 1929 and 1987: This time it's worse!

Many people seek comfort in the assurance that the economic and financial situation today is much sounder than that of the 1920s; and therefore that there are no significant parallels. Our advice: They had better go back to the statistical history of that period! The parallels between the two periods are breathtakingly close:

1. In both periods, the confusion about the underlying realities before the crash stemmed from the very same misconception: the failure to recognize the importance of credit inflation or the real meaning of liquidity.

2. In both periods, this failure to recognize the true inflationary forces was due to the very same phenomenon: the fact that credit inflation went largely into the financing of stock purchases, driving their prices to inflated levels, leaving, however, the price indexes for goods and services relatively untouched.

3. Consequently, in both periods, the combination of (a) stable price indexes and (b) a stock market boom generated a mirage of stability and financial strength.

4. In both periods, the credit inflation preceding the crash had the very same cause: desperate efforts by the Fed to prolong a cyclical recovery beyond its normal lifespan.

5. In both periods, a prolonged period of monetary ease and credit inflation produced widespread over-indebtedness.

6. In both periods, observers were -- and are -- so busy debating whether the phenomenon they are experiencing is inflation or deflation, so wrapped up in trying to decide whether inflationary pressures are present or not, that decision making is largely paralyzed.

The bond market bugaboo.

Perhaps most important to readers of these reports, one must remember that, in both periods, the bond market does not necessarily behave according to Hoyle. The stereotype thinking dictates that if you believe it's inflation, you should sell bonds; if you believe it's deflation, then you should buy them. But history is proof that this black-or-white approach could be a dangerous trap! Rather, before making bond-market decisions, it is essential to understand the developments, first in terms of their complexity, and second in terms of their longer-term dynamics. The first fact which must be recognized is this: During the final years before the 1987 crash, the United States had undergone an accelerating inflation of credit, characterized by a rapidly widening gap between credit creation and available savings.

Yes, it is true that growth in domestic demand set a postwar record. But during 1983-84, most of this inflation went into the soaring trade deficit. And after 1983, it was channeled into the soaring stock prices -- a form of price inflation. This *securities price inflation*, plus the unprecedented import inflation which we have so often stressed in these reports, has diverted the floods of excess money away from consumer prices.

What about the future?

The pundits often stress that the U.S. economy of today is much stronger than it was in the late 1920s; that by October 1929, the U.S. economy had already peaked. This time, they point out, the crash coincided with strong real growth in the third quarter. In our view, the actual growth rate of the economy is one of the least reliable indicators of strength or weakness.

In comparing the two periods, the far more decisive point is the fact that the U.S. economy and its financial system are presently *much more fragile and vulnerable than they were in the late 1920s:*

1. In 1929, the United States was the biggest creditor to the world, with a well-entrenched trade surplus. Today, it is the largest debtor on the planet, with a chronic and huge trade deficit!

2. In 1929, the federal budget was in surplus, effectively giving policy makers much *more* latitude to combat the crash than they have today. This time, by contrast, the extreme U.S. dependence on a continuous and huge influx of foreign capital severely limits the Fed's room to maneuver.

In short, *both fiscal and monetary options are far more limited today than they were in 1929-30.*

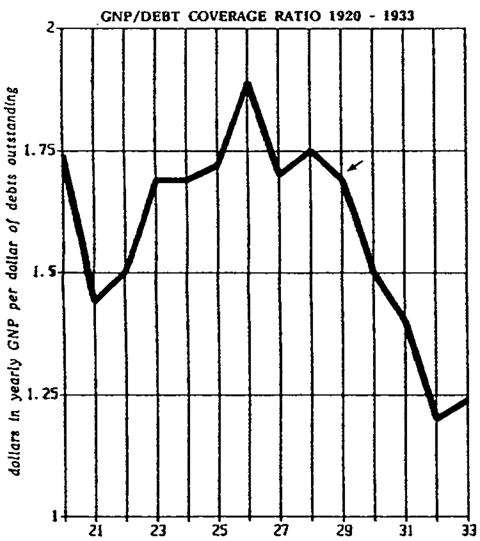
Why then, despite the relative financial strengths of that time, did the United States experience the longest and deepest depression in its history? The fallen prophet, Irving Fisher, wizened by hindsight, provides the answer in 1933: "The Depression out of which we are now emerging is an example of a debt/deflation depression of the most serious sort. The debts of 1929 were the greatest known, both nominally and really, up to that time."

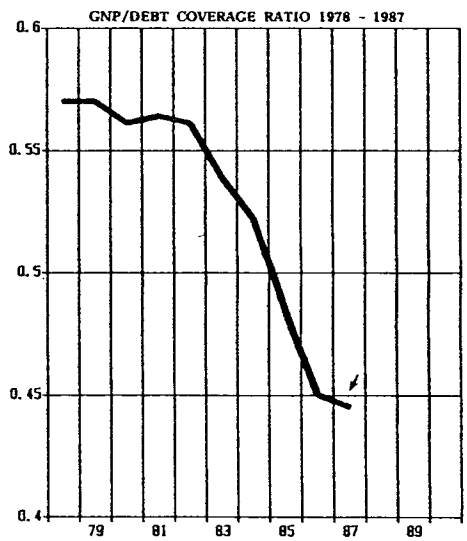
He was absolutely correct. (Finally!) At the time of the October 1929 crash, total indebtedness in the United States came close to $200 billion, up sharply from $153 billion as of year-end 1924. Meanwhile, nominal GNP had grown from $82 billion to

$100 billion. In other words, American individuals, corporations and governments had incurred almost three dollars in additional debt for each dollar of additional goods and services which they produced!

His statement would also be perfectly correct today: From year-end 1983 to mid-1987, total U.S. indebtedness grew by over $3 trillion, compared to a growth of GNP of nearly $1 trillion. Thus, *the debt-to-GNP ratio was almost the same as in the 1920s. In both cases we have roughly a 3 to 1 ratio for the precrash years, compared to a long-term average of around 1.4 to 1.*

If you look at the debt phenomenon in terms of debts *outstanding* rather than growth, it becomes apparent that the 1980s are actually worse than the 1920s. In 1929, to cover every dollar of debts outstanding there was $1.69 in GNP; in 1987 the equivalent figure is only $.45. Moreover, as you can see in the graphs below, this GNP/credit ratio held up well until after the 1929 crash. This time it has fallen sharply well before the crash (compare the position of the arrows), indicating that, in this respect, the speculative excesses have actually been greater this time around.





It is this basic structural similarity between the two periods -- and not the superficial differences in the growth rates -- which tells the true story! Do the historical parallels mean that there will be a replay of the 1930s? In some important aspects, yes; in others, no. Let's take each area one by one:

1. Security markets.

In the 1930s, It was the crashing stock and bond markets that proved the Achilles heel of the financial system. As prices collapsed, the liquidity of most marketable securities simply vanished. But the decisive point -- the one which most historians have overlooked -- is that the chief cause behind this debacle was not so much the *quantity* of money, but rather the well-founded doubts about the *quality* of credit and of earnings. Even the banking crisis is directly traceable to banks' own, overgrown, low-grade bond portfolios.

This time, both Congress and the Federal Reserve have, for all practical purposes, resolved to bail out every bank and every large company. But they have no control whatsoever over the prices of securities and their marketability, much of which is,

by the way, owned by those same banks and companies. In this respect, the handwriting is already clearly on the wall.

Large chunks of the junk bond market in the United States and of the Eurobond market have been hammered -- not only in terms of falling prices, but also with a sharp contraction of liquidity, making it virtually impossible to sell them at any price. Meanwhile, the U.S. stock options markets, which had played such a vital role in the stock market euphoria, *have suffered a dramatic contraction in volume of as much -- sometimes as much as 90%.*

We expect that it is these crashing security prices, coupled to vanishing market liquidity, which, in coming years, are bound to be the most pivotal replay of the 1930s.

2. The dollar, inflation and interest rates.

What then are the *new* elements in the scenario for 1988 and beyond? In a nutshell, they are:

(1) The floating dollar,
(2) the determination of Government to sacrifice the dollar whenever it perceives a need to fight recession, and ...
(3) the huge budget and trade deficits.

It is these three critical factors which will make the big difference when it comes to the relative degree of inflation or deflation as compared to the 1930s.

When the Fed eased aggressively after the 1929 stock market crash, it acted from a position of strength vis-à-vis the outside world. It had the ability to let interest rates fall steeply *without* jeopardizing the fixed exchange rate. Consequently, despite the sharply declining interest rates, the dollar remained strong throughout the crash.

The only event which could possibly be construed as indicating dollar weakness during that period was on the occasion of the Roosevelt devaluation in 1933. But this was only after the British pound had already been devalued in 1931. Moreover, the dollar devaluation was limited and therefore failed to raise domestic prices as Roosevelt had wanted.

This time, the dollar is floating against all important currencies. More importantly, it is fundamentally weaker than ever before. Therefore, any aggressive monetary easing would lead to its collapse as the world would lose all confidence in U.S. policy makers. The key question is: For how long and to what extremes are those policy makers willing to go? Will the threat of a true dollar collapse stand in the way of massive monetary easing?

Our answer is no ... at least not for a long time. Given an election year and considering the whole philosophy of the Reagan Administration, we must assume that, as soon as the U.S. economy is officially pitched into recession, the Fed will open its monetary spigots once again, risking -- and accepting -- a dollar collapse.

There *is* a limit (of sorts) to the extent of the dollar fall which the Fed is willing to tolerate without countermeasures. This limit cannot be defined in terms of a

to tolerate without countermeasures. This limit cannot be defined in terms of a given level or even in terms of the speed of the decline. But it can be delineated, with relative certainty, in terms of the *events which will signal that the limit has been reached: major tremors in the bond and stock markets, plus rising inflation.* Only then, when the cost of the dollar collapse is finally recognized to be greater than the benefits, will the Fed finally respond by raising interest rates. But we fear that, by that time, it will be too little too late.

Finally, we have the ballooning budget deficits, soaring towards the $200 - $250 billion level.

So now we have our conclusion: These three key differences between 1929 and 1987 -- the dollar, the government's posture towards it, and the huge budget deficits -- militate *against* a repeat of the sudden deflationary price and production collapses of the 1930s. But to the degree that this important triad of factors does prevent a 1930s-type economic collapse, it will also have the far more negative impact of driving long-term interest rates higher, *even on Treasuries*, which in turn will eventually deepen the economic declines anyhow. Add to this the quality problem associated with financial turmoil and one can visualize the interest rates of corporate bonds -- especially the lower-grade ones -- going *much higher still.*

There is a natural tendency -- especially among those who are bearish on the stock market and the economy -- to be bullish on U.S. bonds. One reason is that they have read or heard about all of the nonsense written about the causes of the Great Depression. They don't look at the charts themselves and therefore don't realize that most bonds also collapsed in the 1930s. Further, they don't comprehend the real causes of the Great Depression -- let alone the differences with the 1980s. All of these point towards a U.S. bond market which should tend to be relatively *more bearish*, with the weakness coming *relatively earlier* in the cycle than was the case 58 years ago.

3. The economy.

For anyone who is unconfused by Keynesian and monetarist "logic," it is all too clear what the main underlying evils were in both eras: excessive borrowing, excessive credit expansion, too much speculation, and overconsumption (both public and private) -- *everything but productive investment.* And in both eras, it is this lack of capital investment which eventually dooms economic expansion at the end of the boom and the prospects for early economic recovery after the fall.

The borrowing and lending excesses of the 1920s had created an illusion of prosperity and stability which did not exist. So long as the internal and international credit expansion continued to accelerate, the cracks in the economies remained concealed. All the while, the runaway lending was widening those cracks.

The critical period for Germany and all the other overindebted countries had already been reached in 1928, when the economic and financial boom in the United States abruptly siphoned off U.S. funds that otherwise might have gone abroad. Thus, it was the financially weak *debtor* countries that led the march into depression, followed in late 1929 by the United States, also overburdened by *domestic* debt. By contrast, the financially strong countries which had largely avoided the 1920s excesses -- England, the Scandinavian countries and Japan -- fared incomparably better. (France was a mixed case: It had the best performance in

the early 1930s, but became one of the worst performers when the later Socialist government boarded the freight train of easy money, big budget deficits and devaluation.)

It is said that the cessation of international U.S. lending played a great role in causing and spreading the world depression. True. But it was inconceivable that Germany and other countries could have gone on absorbing such large capital imports to finance public spending. All these countries were living on borrowed time as they needed more and more credit simply to pay their soaring interest burden.

Thus, if the 1930s have taught us one lesson with absolute clarity, it is this: The depression will strike the hardest in those nations which have the most debts, either internal or external. Conversely, the past avoidance of financial excesses will afford the best protection against future depressive forces. Departing from this basic principle, one can already begin to delineate where the differences will fall -- between past and future, as well as between the hard-currency nations and the U.S.

Looking back to the beginning of the 1930s, we see how the extreme financial weaknesses in Europe, especially in Germany, intensified their depression. But looking forward to the balance of the 1980s, we see precisely the reverse. We see that most of the industrialized West -- Japan and the Far East, Germany, England and the whole of Europe -- is financially strong. At the same time, the focus of extreme financial weakness is concentrated on the American continents, headquartered in the U.S. This cannot fail to translate, over time, into equally extreme *economic* weakness for that part of the world. *The United States faces economic, financial and monetary problems of a type and severity never before experienced.*

And, still, the symptoms of overindebtedness (higher than normal interest rates) are mistaken for signs of monetary tightness -- precisely as in the 1930s.

4. Government policy.

This wrongful interpretation has dire consequences for the future of monetary and fiscal policy, already merely a shadow of their former selves. It has given rise to the widespread belief that all that is needed to overcome the difficulties is still easier money and still more borrowing. What is overlooked is the fact that the ability to borrow also has definable limits: that point in time when the confidence needed, to support it, simply cracks. Most important of all, it has still not been recognized that, with the stock market crash, just such a point has now been reached.

Conclusion: Government policy will be paralyzed. With every passing day, the government will find itself increasingly blocked from taking effective countermeasures, resorting instead to futile manipulations which only prolong the crisis, hold up inflation and interest rates, and deepen the decline in both the markets and the economy. For the moment, it might appear that the markets have stabilized, that all is under control once again. This last myth, however, will be the first to fall.